Part B. Life Insurance Companies and Products

The current Federal income tax treatment of life insurance companies and their products allows investors in such products to obtain a substantially higher after-tax return than is available on investments whose income is fully taxed on a current basis. The Treasury Department proposals would do away with this special treatment. Deferral on the income earned on the investment of life insurance premiums (other than term insurance) wuld be ended by taxing to the policyholder the annual increase in the cash surrender value of the policy. The same treatment would apply to annuity contracts. Policyholder loans and partial withdrawals would also be taxed to the policyholder, to the extent of any income credited to the policy but not previously taxed to the policyholder.

Special rules that reduce the income tax paid by life insurance companies would also be modified. The life insurance reserve for any contract would be limited to the contract's net surrender value. The special 20-percent life insurance deduction and 60-percent small life insurance company deduction would be repealed.

IMPOSE CURRENT TAXATION ON LIFE INSURANCE INSIDE INTEREST BUILD-UP

General Explanation

Chapter 12.05

Current Law

The premium paid on any life insurance policy (other than a term insurance policy) can be divided into three components: a pure insurance component, a loading component, and an investment or savings component. During any period, the pure insurance component of a policy serves to redistribute funds from policyholders who pay charges for insurance protection to beneficiaries of policyholders who die during the period. The loading component serves to cover the insurance company's expenses and to provide it with a measure of profit. The investment component of a policy arises from the fact that the company can invest funds paid by policyholders between the time the funds are received by the company and the time they are paid out to beneficiaries. The company in turn credits fixed or variable amounts in the nature of interest to the policy, thereby increasing the cash value of the policy and providing a return to the policyholder on his investment in the policy.

Thus, a policyholder who pays a premium in excess of the cost of insurance and loading charges for the year in which the premium is paid is, in effect, making a deposit into a savings account that earns interest for the benefit of the policyholder.

Current law permits life insurance policyholders to earn this income on amounts invested in the policy free of current tax. This untaxed investment income is commonly referred to as "inside interest build-up." The company issuing the policy is allowed a deduction for increases in its insurance reserves. Because the level of reserves relating to a policy increases as interest is credited to the policy, the reserve deduction effectively shields the investment income from tax at the company level.

If a policy fails at any time to satisfy a Federal tax statutory definition of life insurance, which requires that the contract have a significant insurance component, the policy is treated as a combination of term life insurance and an investment fund, with the income generated by the fund being currently taxable to the policyholder.

Any amount paid under a life insurance policy by reason of the death of the insured is excluded from the gross income of the beneficiary. Thus, if a policyholder holds a life insurance policy until his death, the investment income on the policy, which was not taxed when credited to the policy, escapes tax permanently. If a policyholder surrenders his life insurance policy before death in exchange for the policy's cash surrender value or receives distributions in the form of policyholder dividends, the policyholder recognizes ordinary income equal to the excess of the cash received over his net investment in the policy. The policyholder's investment in the policy includes the portion of his premiums that has been used to pay the cost of life insurance. Consequently, any investment income taxed to the policyholder is reduced by the cost of his life insurance, even though this cost is a personal expense of the policyholder and would not be deductible if paid directly.

Reasons for Change

The deregulation of financial institutions and various economic factors have resulted in an increase in the rate of interest paid on traditional investment products (e.g., bank accounts and whole life insurance policies) and a proliferation of competing investment vehicles offered by different types of financial institutions. The effect of these changes has been to increase the already substantial investment orientation of cash value life insurance products. Although the definition of life insurance places some broad limits on the use of life insurance as a tax-favored investment vehicle, it is still possible to design an insurance policy meeting this definition under which the cumulative investment earnings at currently prevailing interest rates are projected to be as much as eight times as large as the cumulative insurance costs. Thus, the favorable tax treatment of inside interest build-up on life insurance policies can be obtained through a contract that provides a relatively small amount of pure insurance coverage.

Interest income on comparable investment vehicles generally is not tax free or tax deferred. Instead, interest income credited on such investments generally is subject to tax whether or not the interest is currently received by the taxpayer. For example, taxpayers generally are subject to current tax on interest credited on certificates of deposit although the interest is not received until the certificate of deposit matures.

Moreover, life insurance is not subject to the significant limitations on the timing and amount of contributions, withdrawals, and loans that apply to other tax-favored investments, such as qualified pension plans and individual retirement accounts (IRAs).

The benefit of deferring or avoiding tax on the inside interest build-up on life insurance policies goes only to individuals with excess disposable income that enables them to save, and particularly to individuals in high tax brackets. This benefit is not available to lower income taxpayers and other individuals buying term insurance since it derives solely from the investment component of a policy (which is not present in a term insurance policy).

The tax-favored treatment of inside interest build-up encourages individuals to save through life insurance companies rather than other financial institutions and perhaps to purchase life insurance that they would not buy except to gain access to the favorable tax treatment of the investment income. This distorts the flow of savings and investment in the economy.

Proposal

Owners of life insurance policies would be treated as being in constructive receipt of the cash surrender value (taking into account any surrender charge or penalty) of their policies. Thus, a policyholder would include in interest income for a taxable year any increase during the taxable year in the amount by which the policy's cash surrender value exceeds the policyholder's investment in the contract. A policyholder's investment in the contract would be equal to the aggregate of his gross premiums, reduced by the aggregate policyholder dividends and other distributions under the policy and by the aggregate cost of renewable term insurance under the policy.

The investment component of a long-term life insurance contract would be eligible for any general savings incentive available to comparable investments. For example, the otherwise-taxable interest income produced by an increase in the cash surrender value of a life insurance contract during a taxable year could be designated as a contribution to an IRA.

Effective Date

The proposal would be effective for all inside interest build-up credited to policies sold on or after January 1, 1986. In the case of policies outstanding on December 31, 1985, inside interest build-up would continue to be free from tax until December 31, 1990. Beginning in 1991, this proposal would be phased in over a five-year period, so that future inside interest build-up on policies sold before January 1, 1986 would be fully subject to tax starting in 1995. Deferral of untaxed inside interest build-up would continue until withdrawal of funds from the policy. See Chapter 12.06. The policyholder's investment in the contract would not be reduced by the cost of term insurance for any period prior to January 1, 1986.

Analysis

Taxing the inside interest build-up on life insurance policies would eliminate the largest tax distortion in the financial services area and would place competing financial products and institutions on more equal footing. This would promote the efficient flow of long-term savings.

Current taxation of inside interest build-up also would eliminate the need for complex rules and restrictions in several areas, including the determination of tax liability when a policy matures or is surrendered and the definition of contracts that qualify as life insurance. For a discussion of how this proposal would affect the treatment of policyholder loans, see Chapter 12.06.

Table 1 shows the distribution of cash value life insurance policies by family economic income. High-income families are more likely to have cash value policies as well as larger policies. The average annual tax-deferred interest income earned on life insurance and annuity policies in 1983 is estimated at $3,050 for families with income greater than $200,000 and less than $200 for families with income less than $30,000. Because the purchase of life insurance policies for predominantly investment purposes is a recent development, the difference between the amount of inside interest build-up earned by wealthier individuals and that earned by less wealthy individuals is expected to grow in the future.

Table 1

Distribution of Ownership of Cash-Value Life Insurance Policies and the Annual Inside Interest Build-up 1/
By Economic Income - 1983

Family Economic Income	Families with Cash-Value Life Insurance Policies Percentage	Average Annual Inside Build-up 2/
$ 0 - 9,999	13	$ 85
10,000 - 14,999	25	110
15,000 - 19,999	33	135
20,000 - 29,999	41	190
30,000 - 49,999	53	310
50,000 - 99,999	68	520
100,000 - 199,999	78	1,240
200,000 or more	70	3,050
All Families	42	$ 355

Office of the Secretary of the Treasury
Office of Tax Analysis

November 29, 1984

1/ Includes annuities.
2/ For those with policies.

Source: Treasury estimates.

It is anticipated that many low- and middle-income individuals who currently own relatively small amounts of cash value life insurance and who would not otherwise maintain IRAs will designate their existing policies as IRAs. If the annual premium (net of policyholder dividends) plus the inside interest build-up on the policy does not exceed the applicable IRA limit, the inside interest build-up would continue, in effect, to be free from current tax. However, the rules respecting the timing of distributions from IRAs would apply and any cash value held in a life insurance IRA at the policyholder's death would be taxed to the beneficiary like any other IRA distribution. (The excess of the death proceeds over the cash value would be exempt from tax, as under current law.)

REVISE TAXATION OF POLICYHOLDER LOANS AND PARTIAL WITHDRAWALS

General Explanation

Chapter 12.06

Current Law

Life insurance policies normally permit the policyholder to borrow funds from the life insurance company in an amount up to the cash value of the policy. Until repaid, the amount of a policyholder loan reduces the proceeds payable to the policyholder in the event of a surrender of the policy or to the beneficiaries in the event of the death of the policyholder.

Policyholder loans are respected as loans and are not treated as withdrawals from the policy, even if the loans are not repaid prior to the death of the insured. Moreover, subject to certain restrictions, interest paid on policyholder loans is deductible by the policyholder even though the policy's inside interest build-up is not subject to current tax.

Generally, if a policyholder withdraws cash from his policy, he is treated as recovering first his investment in the policy. Only after the entire investment has been recovered is the excess amount withdrawn subject to tax. However, a special rule in the definition of life insurance provides that if cash is withdrawn from a policy as a result of a reduction of future death benefits under the policy, the cash will be treated as "boot" in an exchange transaction and subject to tax.

Reasons for Change

Because the inside interest build-up on life insurance policies is not taxed until withdrawal, and is not taxed at all if the policy is held until death, interest deductions from policyholder loans can be used to shelter other taxable income. Currently, life insurance companies are able to market policies with fixed borrowing schedules that provide substantial tax advantages to the policyholder. Under some of these plans, the tax advantages are so large that they have been marketed primarily as tax shelters and only incidentally as life insurance.

Through a partial withdrawal of the cash surrender value from a life insurance policy, a policyholder may receive back an amount that does not exceed his investment in the policy free from tax. A policyholder should not be allowed to cash in his investment while continuing to defer the payment of tax on income from that investment.

Borrowing against the cash value of a life insurance policy reduces the total amount invested by the individual in the policy and has the effect of a partial withdrawal of the policy's cash surrender value. These economically equivalent transactions should be accorded equivalent tax treatment.

Although current taxation of inside interest build-up is proposed in Chapter 12.05, the transitional rule under that proposal would permit the continued deferral of tax on certain inside interest build-up for policies outstanding on December 31, 1985. Accordingly, even if the proposal in Chapter 12.05 is adopted, a revision of the policyholder loan and partial withdrawal rules is needed as a temporary measure.

Proposal

Policyholder loans and partial withdrawals under a policy (not including policyholder dividends and similar distributions), to the extent of any income credited to the policy but not yet included in the taxable income of the policyholder, would be treated as a distribution of such income to the policyholder. The amount of income treated as distributed to the policyholder would be limited to the excess of the cash surrender value of the policy (taking into account any surrender charge or penalty) over the policyholder's investment in the contract. The policyholder's investment in the contract would equal the aggregate amount of premiums paid for the contract reduced by the sum of the aggregate amount of policyholder dividends and similar distributions and the aggregate cost of insurance, taking into account only the cost of insurance after December 31, 1985.

Effective Date

The proposal would apply to policyholder loans and partial withdrawals made on or after January 1, 1986. In addition, all policyholder loans outstanding on December 31, 1985, to the extent not repaid before January 1, 1991, would be treated as new loans to which the proposal applies.

Analysis

The treatment of policyholder loans and partial withdrawals as distributions coming first out of any untaxed investment income under the policy ensures that the tax deferral of inside interest build-up occurring prior to the effective date of these proposals will continue only as long as savings and investment income are retained in the policy. The treatment of outstanding loans not repaid before January 1, 1991 as new loans subject to the proposal would reduce an otherwise strong incentive for policyholders to withdraw funds through policyholder loans shortly before the effective date of the proposal.

The need for this rule (and for the provisions of current law prescribing special treatment of policyholder loans) will disappear after all policies containing untaxed inside interest build-up mature or are surrendered. However, if the proposal in Chapter 12.05 to tax currently the inside interest build-up on life insurance policies is not adopted, this proposal would be needed as a permanent rule.

IMPOSE CURRENT TAXATION ON DEFERRED ANNUITY INVESTMENT INCOME

General Explanation

Chapter 12.07

Current Law

Income credited to a deferred annuity contract is not taxed currently to the owner of the contract or to the insurance company issuing the contract. In general, amounts received by the owner of an annuity contract before the annuity starting date (including loans under the contract) are taxed as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. A portion of each distribution received after the annuity starting date is taxed as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received. Penalties are imposed on certain premature distributions under an annuity contract.

Reasons for Change

Investment income earned on deferred annuities is similar to investment income earned on other savings instruments with other financial institutions. Interest on savings accounts and certificates of deposits is taxed currently, however, while investment income earned on annuities is not taxed until withdrawal. Moreover, deferred annuities are not subject to the significant limitations on the timing and amount of investments that apply to other tax-favored investments, such as pension plans and individual retirement accounts (IRAs). Yet deferred annuity savings are more likely than other tax-favored investments to be withdrawn before retirement because of the smaller withdrawal penalty.

Since tax-favored annuities can be purchased only from life insurance companies, this tax deferral directs the flow of savings toward life insurance companies and away from other financial institutions. There is no reason to favor savings through insurance companies over savings through competing financial institutions.

The deferral of tax on investment income credited to deferred annuities is available only to persons with disposable income available for savings and is of greatest benefit to persons in the highest tax brackets. The tax deferral thus favors wealthier individuals.

Proposal

Owners of deferred annuity contracts would be treated as being in constructive receipt of the cash value (taking into account any surrender charge or penalty) of their contracts. Thus, the owner would include in interest income for a taxable year any increase during the taxable year in the amount by which the contract's cash value exceeds the owner's investment in the contract.

A deferred annuity contract would be eligible for any general savings incentive available to comparable investments. For example, the otherwise-taxable interest income produced by an increase in the cash surrender value of a deferred annuity contract during a taxable year could be designated as a contribution to an IRA.

Effective Date

The proposal would be effective for all investment income credited to contracts sold on or after Jauary 1, 1986. In the case of contracts outstanding on December 31, 1985, investment income credited to the contracts would continue to be untaxed until December 31, 1990. Beginning in 1991, this proposal would be phased in over a five-year period, so that future income credited to contracts outstanding on December 31, 1985 would be fully subject to tax starting in 1995. Deferral of untaxed investment income credited to a contract would continue until withdrawal or distribution of funds from the policy. The penalty imposed on premature distributions under a deferred annuity contract would be repealed for distributions on or after January 1, 1986. All of the other provisions prescribing special treatment of distributions under annuity contracts before the annuity starting date would become obsolete as annuities containing untaxed investment income are surrendered or mature.

Analysis

Taxing the investment income credited to deferred annuity contracts would eliminate a major distortion in the financial services area and would place competing financial products and institutions on more equal footing. This would permit the efficient flow of long-term savings.

Since life insurance companies selling deferred annuities are accustomed to designing investment vehicles to provide for policyholders' retirement, it can be anticipated that companies currently selling deferred annuities will be able to compete effectively for IRA investments. For example, life annuities sold by life insurance companies are the only financial instrument to insure against living beyond one's wealth after retirement. An IRA maintained with a life insurance company may be attractive to investors since a life annuity is available as a direct settlement option, avoiding the need for a rollover from an IRA maintained with another financial institution into a separate annuity IRA upon retirement.

LIMIT LIFE INSURANCE COMPANY RESERVE DEDUCTION

General Explanation

Chapter 12.08

Current Law

The gross amount of premiums received by a life insurance company is included in the taxable income of the company. As described in Chapter 12.05, the premium paid on any life insurance policy (other than a term insurance policy) can be divided into a loading component, a term insurance component, and a savings component. The savings component of a premium is held, in effect, for the benefit of the policyholder in an interest-bearing account. The savings component is needed to help fund the higher cost of insurance protection in later years and is currently available to the policyholder in the form of the policy's cash surrender value.

Life insurance companies are allowed a deduction from taxable income for any net increase in life insurance and other reserves and must include in income any net decrease in reserves. The life insurance reserve for any contract is the greater of the net cash value of the contract (taking into account any surrender penalty or charge) or the reserve for policy claims determined under a prescribed set of rules (based on prevailing State regulatory requirements) relating to the reserve method, assumed interest rate, and assumed mortality or morbidity rate. These latter rules attempt to measure the amount needed to fund the anticipated excess of the present value of future claims and benefits to be paid under the policy over the present value of future premiums (if any) to be received under the policy. The reserve deduction thus serves to adjust the company's income to account for its liability to pay, in the event of a surrender of the policy, the cash value or, in the event of a claim under the policy, the face amount of the policy.

Reasons for Change

Like the receipt of savings deposits by a bank, the receipt of the savings component of life insurance premiums should not be taxed to the company. However, the remaining portions of the gross premiums -- the loading component and the term insurance component -- should be taxed to the company, with corresponding deductions for sales and administrative costs and the payment of claims. Thus, if gross premiums are included in the gross income of the company, an offsetting deduction for the savings component of the premiums is appropriate.

The allowance of a reserve deduction for the increase during the taxable year in the greater of the policy's cash surrender value or the reserve for policy claims often will overstate the company's reserve deduction, especially in the initial years of the policy. This is because the reserve for policy claims, i.e., the estimate of the excess of the present value of future claims and benefits over the present value of future premiums, is calculated using conservative assumptions required for State regulatory purposes.

A reserve deduction equal to the increase in the cash surrender value of a policy generally would be sufficient to exclude the savings component of gross premiums from the company's taxable income and allow a deduction for the exact amount of interest credited to the policyholder's savings account. Moreover, the policy's cash surrender value is an objective measure of the reserve for policy claims needed by the company. This is because the cash surrender value is, in effect, the amount the company is willing to give to the policyholder if he gives up his right to claims and benefits under the policy.

The initial overstatement of reserves allowed under current law results in tax deferral and a reduced effective tax rate for life insurance companies. This enables life insurance companies to offer policyholders higher rates of return on savings or lower costs of insurance, thereby attracting investment dollars from other financial institutions.

Proposal

For tax purposes, the life insurance reserves for any contract would be limited to the net cash surrender value of the contract (taking into account any surrender penalty or charge). The reserve deduction would be adjusted to reflect the indexing of interest. See Chapter 9.03.

Effective Date

The proposal would be effective for policies sold on or after January 1, 1986.

Analysis

Restricting life insurance companies' deductions for additions to reserves to the increase in the cash surrender value of policies issued by the company would be consistent with the separation of income and liabilities of other financial institutions. The actual amount of the savings deposits included in life insurance premiums effectively would be excluded from taxable income. Similarly, the actual amount of interest credited to policyholders would be deducted by the company and, as proposed in Chapter 12.05, included in the income of the policyholders. This would eliminate the different tax treatment of savings at the company level between life insurance companies and depository institutions.

Life insurance companies would increase their premiums (or earn lower profits) as a result of any increased tax liability resulting from the more accurate measurement of their taxable income.

REPEAL SPECIAL LIFE INSURANCE COMPANY DEDUCTIONS

General Explanation

Chapter 12.09

Current Law

All life insurance companies are allowed a deduction equal to 20 percent of their otherwise taxable income. In addition, a small life insurance company is allowed a deduction equal to 60 percent of the first $3 million of its otherwise taxable income. This deduction phases out as otherwise taxable income increases from $3 million to $15 million. The small company deduction is allowed only to companies with gross assets of less than $500 million. Consolidated group tests generally are used in applying the taxable income and gross asset standards.

Reasons for Change

The special deduction for all life insurance companies was enacted to reduce the competitive impact of the Tax Reform Act of 1984, which broadened the tax base of life insurance companies without similarly broadening the tax base for competing financial institutions. Enactment of comprehensive tax reform that affects all financial institutions and reduces the maximum marginal tax rate would eliminate the justification for the special deduction for life insurance companies. Retention of the special deduction for life insurance companies would be unfair to their competitors and would cause tax-induced economic distortions.

Similarly, the special deduction for small life insurance companies was a deviation from the proper measurement of economic income to prevent a dramatic increase in the tax burden of small life insurance companies as a result of the 1984 Act. After comprehensive tax reform, special rules for small life insurance companies would no longer be appropriate.

Proposal

The special life insurance company deduction and small life insurance company deduction would be repealed.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The revision of the tax rules governing life insurance companies in 1984 essentially broadened their tax bases and reduced their effective marginal tax rates. Repeal of the special 20 percent deduction provision would be more than offset by the reduction in the maximum corporate tax rate. The 20 percent deduction of otherwise taxable income lowers life insurance companies' effective marginal tax rate to 36.8 percent. The Treasury Department proposals would lower the corporate rate to 33 percent.

Small life insurance companies would be placed on a par with all other life insurance companies and other small corporations. Elimination of preferential tax rates based on the size of the firm would end tax-induced distortions that favor sales of life insurance through small firms.